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# **Agricultural Outlook Forum 1999**



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## **Speech Booklet 4**

**Tuesday, February 23**

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### **8:00 - 9:30     GRAINS AND OILSEEDS OUTLOOK**

#### **Nebraska Agriculture, Present and Future**

Ed Schrock, Farmer and Nebraska State Senator

### **8:00 - 9:30     COTTON OUTLOOK**

#### **U.S. Perspective on the Outlook for Cotton**

Pete Burr, Stephen MacDonald, Leslie A. Meyer and Carol Skelly, Agricultural Economists, USDA

#### **Meeting the Challenges of Producing Cotton in the United States**

Dr. O.A. Cleveland, Professor of Agricultural Economics and Marketing Specialist, Mississippi State University Extension Service

#### **New Direction in China's Cotton Policy**

Shi Jian Wei, Director-General, Bureau of Cotton and Jute, All-China Federation of Supply and Marketing Cooperatives

### **8:00-9:30     NEW BUSINESS STRATEGIES IN A COMPETITIVE FRUITS AND VEGETABLES ECONOMY**

#### **Adapting to Market Changes**

A. G. Kawamura, President, Western Marketing Company of California

### **10:00-11:30     NORTH AMERICAN LIVESTOCK AND POULTRY OUTLOOK**

#### **U.S. Outlook for Livestock and Poultry**

Shayle Shagam, Livestock Analyst, World Agricultural Outlook Board, USDA

### **12:10-1:30     COTTON LUNCHEON**

#### **The Globalization of the U.S. Cotton Market**

Sharon C. Johnson, Cotton Analyst, Frank Schneider and Company

### **1:45-3:45     DAIRY OUTLOOK**

#### **Outlook for Dairy**

Jim J. Miller, Agricultural Economist, Economic Research Service, USDA

## NEBRASKA AGRICULTURE – PRESENT AND FUTURE

Senator Ed Schrock  
Nebraska State Legislature

I am a third generation farmer. My great grandmother moved to Nebraska in 1889. She was a widow and moved to Nebraska along with her 12-year-old son – my grandfather. They lived in a dugout through their first winter in south central Nebraska. So, my family's roots are deep in the soil of Nebraska. I farm with my father, two brothers and two sons. We raise irrigated corn, soybeans, specialty crops (popcorn and white corn), and wheat. We have a cow and calf operation and we have finished cattle in area feed lots. I sit on the Agriculture Committee in the Nebraska Legislature and am chairman of the Natural Resources Committee.

I would like to give credit to University of Nebraska-Lincoln agricultural economist Professor Roy Frederick for much of the statistical information contained in this speech. Dr. Frederick, who previously served as Director of Agriculture for the State of Nebraska, is currently with the Institute of Agriculture and Natural Resources at the University of Nebraska-Lincoln. Many of the statistics I will cite have been generated by the Nebraska Farm Business Association, an association of 480 Nebraska farms who input and share data with the Institute of Agriculture and Natural Resources for the mutual benefit of the association's members.

Historically, Nebraska is third overall among states in the production of corn and second in cattle on feed. We are an agricultural state. The state of the agricultural economy in Nebraska is not good. When final totals become available, 1998 net farm income will have been the lowest since the 1983-84 period. We continue to see about 3% annual attrition in the total number of family farms. I believe this percentage will increase during 1999.

As you know, the major problem is low commodity prices. Prices for most commodities produced in our state – corn, soybeans, wheat, sorghum, hay, fed cattle, feeder cattle and hogs – have been below year-earlier levels since about July 1, 1998. These price comparisons are even more meaningful when you realize that Nebraska net farm income in 1997 was down 40% from the previous year. In other words, what we are seeing is a continuation of a downward trend in what were already low prices.

Of course individual situations can vary widely from the overview I've just described. For example, a producer who forward contracted much of his or her 1998 crop production early in the year generally did better than one who waited until harvest to sell. In fact, the combination of forward contracting, loan deficiency payments and additional direct payments from the federal government late in the year allowed some producers to do very well. Higher than normal yields, especially for dryland crops also helped.

In general, those who had hog or cow-calf operations and did little or no forward contracting on their crops appear to have had the lowest net incomes. All hog operations lost

money in 1998. Final figures are not yet in, but the Nebraska Farm Business Association estimates (from the 480 farms reporting) an average per farm loss of \$2,000 from operations in 1998.

I won't spend much time on the factors that have contributed to lower commodity prices, but in brief, two items may be worth singling out:

First, red meat supplies have been large. For example, U.S. commercial red meat slaughter during December 1998 was up 6% from the previous year. More importantly, total red meats in cold storage at the end of that month were 14% higher than on the same date one-year earlier. Pork supplies alone were up 46%. I believe this is due in large measure to the relatively low prices for feed grain. Given the large carryover stocks of grain, I am not optimistic regarding future prices in the meat sector.

Second, U.S. agricultural exports are projected at just over \$50 billion for fiscal year 1999. This will be the third consecutive year of falling exports, after peaking near \$60 billion in fiscal year 1996. As exports have sagged, U.S. carryover stocks of corn, wheat and soybeans have more than doubled. Under "Freedom to Farm," we were promised an aggressive program of exports. We remain the supplier of last resort. That's sad.

It is estimated that carryover stocks of corn, wheat and soybeans will have doubled over the period from September 1997 to September 1999. Probably no statistic is more telling in terms of forward effect on commodity prices than is carryover stock of grain products. Stocks of red meats and other livestock products also have been impacted by the poor export situation.

It's important to remember that 60% of U.S. land under cultivation can feed our population. We do have excess capacity and so I emphasize the foreign market situation. If there are to be no supply control programs and if we are to plant fencerow to fencerow, we need to continue to develop our foreign markets. For most of the past 25 years, there has been a very strong correlation between agricultural exports and U.S. commodity prices. While our production can vary from year to year because of weather, livestock production cycles and other factors, the fact is that American agriculture seems to have done well when the export market is vibrant and not so well when foreign sales sag.

U.S. agricultural exports increased dramatically from 1972 until impact by the Carter grain embargo and its lingering long term damage to foreign markets. Exports did not rebound until 1986. Starting in 1986 and through 1995, exports increased from \$25 billion to \$60 billion annually, before falling the past three years. Exports typically account for only about 25% of gross farm income nationally. But we know that it sometimes doesn't take much of a change in demand to lead to much larger relative changes in commodity prices and farm income. Adding to the unpredictability (and the resulting instability) in this area, in relative terms exports tend to shift more dramatically year-to-year than do changes in domestic demand.

While ups and downs occur in commodity prices and incomes, there is no real indication that we are permanently and chronically overproducing for the market. It's just that in certain years, or even periods of years, we don't have a good balance between production and foreign demand for our agricultural products. The instability problem is made worse because each

producer knows that independently changing his or her production will have no influence on what happens in the sector as a whole.

When economic conditions deteriorate, we should be especially concerned about what we call middle-sized farms. This category of farms is neither the small, hobby-type where most of the family income is earned off the farm nor the large operations that gross \$500,000 a year or more. It's somewhere in the middle. It often includes beginning farmers or farmers who are at least still relatively early in their careers and trying to expand their operations. In a sense, this is the "incubator" category – the independent farmers of our future.

To put the plight of the middle-sized farmer in perspective, if we look at the recently-released 1997 Census of Agriculture, we see the following: In Nebraska, the overall number of farms and ranches is declining. However, the total number of large farms (gross sales of over \$500,000) are on the increase. Simultaneously, the total number of hobby-type farms (gross sales of \$10,000 or less) are also increasing. This combination of events left the number of middle-size farms down by over 10% so far this decade.

What about the role of government in addressing some of the challenges confronting the agricultural sector? First, it always has been (and probably always will be) difficult for government to design policy that is both equitable and efficient. Farm operations vary too much by size, locality, enterprise mix, debt status, management ability and other factors. With all due respect to congressional efforts to be fair, the fact is that government support is never enough for some operations and more than needed for others.

Having said that, I generally think government-subsidized crop insurance makes a great deal of sense. It can take into account different levels of risk by locality and by crop. It can protect prices as well as production. But there are still questions about how much risk the government should underwrite and how much should be the responsibility of producers.

There's no question that price supports and direct payments have been helpful to many producers over the years. However, traditional support programs have limitations in that they cover only a relative handful of agricultural commodities. Moreover, to the extent these programs have been linked with production adjustments, they haven't been very effective. Too much slippage occurs, primarily because the poorest land on the farm is always the land retired from production. For these reasons I would like to see the government safety net of the future focus mostly on crop insurance-type programs.

From the farmers' standpoint, risk reduction is appealing, but what is the exposure to the federal government once the risk is shifted? With a 10-bushel corn crop and low harvest-time prices, the federal government would have to pay out \$100 million in loan deficiency payments for every penny that the price dropped below \$1.89 (the national average loan rate). Other commodities (wheat, sorghum, soybeans, cotton, etc.) would be added to this total. What if corn was \$1.39 per bushel? That's another \$5 billion exposure to the federal treasury. Add to that the federal exposure on the crop insurance program. Was it Everett Dirksen who said, "A billion here, a billion there – pretty soon you're talking about some real money."

Federal direct payments for fiscal year 1999 are scheduled at \$5.6 billion. In addition, the federal government has about \$2 billion already invested in the crop insurance program for

this year. Private insurance companies would bear the cost of indemnities for losses under crop revenue coverage this year. You can bet that if there were massive losses under crop revenue coverage, the insurance companies would come back with a request for much larger subsidies from the federal government next year.

These are long term concerns, but as a farmer, what is my immediate experience and what are my expectations? On my own farm, I've been unable to rebid 75 acres of CRP ground. My first contract was for \$60 per acre. Currently CRP ground is paying \$40 per acre – a 33% decline. We keep approximately 1000 head of cattle on feed in a neighboring commercial feed lot. Our loss per head averaged about \$100 per head. We turned those cattle three times, thus losing about \$300,000 in 1998. That will get you out of the market real quick. I sold alfalfa hay last year at this time for \$85 per ton. Today I am bid \$40 per ton.

As our profits are squeezed or turned into losses, what is the net result on our underlying productive asset, our land? Over the past ten years, the value of our land has remained static and corrected for inflation, it has probably gone down in value. If we had sold our land ten years ago and invested the proceeds in the stock market, we would have more than tripled our money. So, are we in the trough of a cycle or are we looking at a long term downward trend in American agriculture? As a farmer, this is the question you have to ask yourself. My sons are 27 and 29. Both are college educated. We see many young men and women leaving the farm. Are they well advised to do so? Should the fourth generation of my farm family now make a decision to leave the land? It is their home, their livelihood, their history and their identity as a family. Is it now time for such young people to look away from the land and leave farming to the ever-growing corporate farming operations? Maybe it is, but I would hope not. There are no easy answers and the outlook is of course grim, but we are a hardy and optimistic lot. All we ask is a modicum of predictability, access to foreign markets and a level playing field.

## **USDA PERSPECTIVE ON THE OUTLOOK FOR COTTON**

Pete Burr, Stephen MacDonald, Leslie Meyer, and Carol Skelly  
Agricultural Economists, USDA

### **World Cotton Situation for 1998/99**

The world cotton situation for 1998/99 is characterized by falling production, consumption, and trade. However, concern has focused on falling consumption, and world prices have fallen to levels not seen since the early 1990's. World consumption is forecast at 84.6 million bales in 1998/99, 3.8 million below its year earlier level, the largest annual percentage decline (4.2 percent) since the early 1970's. World production in 1998/99 is estimated 6.7 million bales below its year earlier level, at 84.7 million. Higher world ending stocks are expected for the fifth consecutive year in 1998/99, 500,000 bales higher than a year earlier at 41.6 million bales, or 49 percent of world consumption.

### **Foreign Cotton Situation for 1998/99**

#### **Foreign Area, Yield and Production**

Foreign cotton area rose slightly in 1998/99, up 1 percent to 28.5 million hectares. However, foreign production is estimated lower nonetheless, down 1.7 million to bales to 71 million. Foreign yields fell on average during 1998/99 since production declines were concentrated in countries where irrigated production and high yields predominate, and larger crops were recorded in countries with some of the lowest yields in the world.

Increased foreign area was led by India's 300,000 hectare gain as declining Indian stocks in 1997/98 fueled higher prices, driving area there to its highest ever. Australia's area increase was the second largest of any country in 1998/99 as favorable pricing opportunities against New York futures coincided with favorable water supplies. Timely precipitation and low grain prices discouraged wheat plantings in favor of cotton across an unprecedented amount of dryland area, and Australia's total cotton area is estimated to have risen 100,000 hectares, or nearly 25 percent. At 540,000 hectares, Australian area marked its fourth consecutive annual increase to a new all-time high. Finally, with increases in South Africa, Zimbabwe, and a variety of countries in West Africa's Franc Zone, cotton area in Sub-Saharan Africa rose 200,000 hectares from the year before, its fifth consecutive increase. With this increase, Sub-Saharan Africa's area reached a record 4.3 million hectares, surpassing the 4 million hectare record set in 1971.

Area fell 100,000 hectares in China, and nearly 100,000 hectares in Egypt, as government policy in each country helped reduce the attractiveness of cotton production. Adverse weather helped

drive Sudan's area about 100,000 hectares lower as well, and the adverse economic events of the last year contributed to lower area in Argentina and Paraguay.

Foreign production in 1998/99 is estimated lower than the year before as lower production in China, Egypt, Pakistan, and other countries offset larger crops in India, Australia, and Turkey. According to China's State Statistical Bureau's initial estimate, China's 1998/99 crop totaled about 19.8 million bales, 1.3 million below the previous year. Yields fell from the previous year's record high, but were the second largest ever. Xinjiang continued to account for an ever larger share of China's cotton crop, and its high yields supported national average yields despite the impact of the summer's floods in southeastern growing regions. The Egyptian government introduced several reforms in 1998/99--including reduced pesticide subsidies for farmers, liberalization of land rental rates, and reduced purchase prices--and the crop is estimated to have fallen nearly one-third, a 500,000 bale decline, due to lower area and the effects of excessive heat on yields. Weather and insect problems continued to weigh on Pakistan's yields, and Pakistan's 1998/99 crop was nearly 400,000 bales lower than the year before.

#### Foreign Consumption, Trade, and Ending Stocks

The economic slowdown triggered by the Asian financial crisis has taken a heavy toll on foreign cotton consumption in 1998/99. At 74.2 million bales, foreign consumption for the year is estimated to have fallen 3.9 percent, the largest such drop of the post-World War II era. With this 2.8-million-bale decline, foreign cotton consumption is now forecast to be at its lowest since 1985.

According to Oxford Economic Forecasting, world economic growth is estimated at barely 2 percent in both 1998 and 1999, substantially lower than average 3.2 percent world GDP increases of the preceding four years. Southeast Asia is expected to improve in 1999, and suffer only a 1-percent decline in GDP, compared with its 6.7 percent contraction in 1998. Deterioration is expected for the transition economies, where average GDP growth is expected to go from -2.3 percent in 1998 to -7.3 percent in 1999, as the Asian crisis's delayed impact hits Russia. Similarly, a Brazilian economic contraction in 1999 is expected to bring total Latin American GDP growth to its lowest in four years. Finally, Japan's economy is expected to contract for the second consecutive year in 1999.

As a result, reduced consumer demand in Southeast Asia, Japan, Russia, and Brazil appears to be offsetting what to date has been relatively robust consumer demand in the United States and Western Europe. Textile exports that would otherwise be going to Japan, Russia, and Brazil have in effect been diverted to other markets, and textile products that would have otherwise met domestic needs in Southeast Asia have moved onto export markets, further heightening the competition in markets that can still import.

Consumption in both China and Turkey is expected to be 1 million bales lower than the year before under the impacts of slowing domestic economies, poor growth in major textile export markets, and increased competition from other textile exporters. China's calendar 1998 textile and apparel export value fell 7.3 percent from the preceding year, and a successful implementation

of the on-again, off-again spindle-reduction campaign China has pursued for many years reportedly led to the destruction of millions of cotton spindles during calendar 1998.

India's consumption is forecast nearly 600,000 bales below the year before due both to its own slowing economy and to difficult competition in world textile trade from East and Southeast Asian exporters. Domestic economic problems associated with the aftershocks of the Asian financial crisis have reduced expectations for economic growth and cotton consumption in Russia and Brazil, with respective year-to-year declines in consumption of 350,000 and 150,000 bales.

Foreign cotton imports are also expected to decline in 1998/99, down 2.6 million bales to 24.1 million. Not surprisingly, the countries with the largest expected consumption declines are those with the largest expected declines in imports. China's imports are forecast 1.2 million bales lower than the year before; Turkey's imports, 1.1 million bales lower; and Brazil's and Russia's each about 400,000 bales lower. Smaller increases in imports are foreseen for India, Pakistan, Bangladesh, and Southeast Asia.

As foreign consumption slows more than exports in 1998/99, foreign stocks are expected to increase. Virtually all of the anticipated 1-million-bale increase in foreign stocks is expected to occur in India. The combination of slowing consumption, rising production, and increased imports is expected to lead to a 1.2-million-bale increase in India's stocks, and the highest ending stocks-to-use ratio there since 1985. Lower stocks are forecast for China for the first time since 1993/94, but only a 250,000-bale decline. Egypt's cotton stocks are forecast nearly 400,000 bales lower, accounting for about half of the 250 percent increase in stocks that occurred between 1995 and 1997.

## **U.S. Cotton Situation for 1998/99**

### **U.S. Area, Yield, and Production**

U.S. cotton production in 1998/99 is currently estimated at 13.8 million bales, compared with last season's 18.8-million-bale crop. This season's U.S. production decline was the result of lower planted area, harvested area, and yield. Planted area of 13.4 million acres was 3.5 percent below the preceding year due to more attractive alternative crops and adverse weather at planting time, especially in the Southwest and West regions. Upland area totaled nearly 13.1 million acres while the extra-long staple (ELS) acreage expanded to 330,000 acres. In addition, this season's drought conditions forced producers to abandon 20 percent of the area planted, a much larger than normal abandonment. Estimated harvested area of 10.7 million acres reflects a 23-percent reduction from 1997/98. And despite the loss of lower-yielding dryland acres, the national yield of 618 pounds per harvested acre is 8 percent lower than a year ago.

Upland production is estimated at 13.37 million bales this season, with an average yield of only 612 pounds per harvested acre. With U.S. production substantially below last season, each of the four cotton regions produced a smaller crop than in 1997/98, the result of lower area and yields in three of the four regions. Only the Southwest planted more upland acreage in 1998/99 than in 1997/98. However, excessive heat and drought conditions in this region caused a record 41

percent abandonment rate, leaving the Southwest's harvested area at a historical low 3.4 million acres. As a result, a larger percentage of the Southwest crop was under irrigation in 1998/99 which bolstered the region's yield to 510 pounds per harvested acre.

In the Delta, cotton planted area, at 3.2 million acres, continued its 3-year decline as competing crop prices took acreage out of cotton once again in 1998/99. And with yields significantly below the previous season, upland production in the Delta reached only 4.2 million bales, the lowest in 10 years. In the Southeast, 1998/99 planted area was above the 5-year average at 3.1 million acres. However, weather problems also affected yields in this region, forcing production to fall to 3.7 million bales, the lowest in 4 seasons. North Carolina was the only exception, however, as cotton area, yield, and production were higher than last season. In the West, upland area fell below a million acres for the first time since 1967/68 as a result of weather problems at planting time. In addition, yields fell to 943 pounds per harvested acre for an upland crop of only 1.8 million bales for the region, the lowest in over 25 years.

Meanwhile, ELS cotton production is estimated lower this season at 430,000 bales. The decline in the ELS crop is attributable to a decrease in both harvested area and yields. Harvested area totaled 237,000 acres while the ELS yield averaged 873 pounds per harvested acre. With ELS production reduced over 100,000 bales this season, California continues to increase its dominance of the ELS crop, accounting for 80 percent of the 1998/99 production.

#### U.S. Mill Use, 1998/99

U.S. cotton mill demand is expected to decline in 1998/99 despite the continued strength in the retail market for cotton products. Much of the consumer demand, however, has been filled with less expensive imported textile products from many countries still struggling with recent economic crises. As a result of these textile imports, U.S. mills have been forced to curtail production to alleviate the buildup of inventories.

U.S. cotton mill use is projected to fall nearly one million bales this season to 10.4 million, 8 percent below 1997/98's 50-year high. Upland mill use is expected to approach 10.3 million bales while ELS consumption is projected to reach 110,000 bales. During the first 5 months of 1998/99, U.S. mills used 4.3 million bales of cotton, about 9 percent below the comparable period for 1997/98. And despite seasonal slowdowns seen in recent data from the Department of Commerce, the seasonally adjusted annual rate of cotton consumption has averaged over 10.5 million bales for the August through December period.

Slower growth in the U.S. economy, reduced U.S. supplies, and the rising textile imports, which have widened the cotton textile trade deficit, will help moderate mill use this season. And despite lower manmade fiber prices, declines in cotton mill use have been exceeded by decreases in manmade fiber usage. As a result, cotton has averaged nearly an 80-percent share on the cotton spinning system during the first 5 months of 1998/99, compared with 78.5 percent for the entire 1997/98 season.

U.S. cotton textile imports, textile exports, and the net trade deficit all rose in calendar 1998.

Cotton textile imports increased nearly 20 percent and approached 6 billion pounds, or the equivalent of 12.5 million bales of raw cotton. On the other hand, U.S. cotton textile exports in 1998 gained over 10 percent reaching approximately 2 billion pounds, or the equivalent of 4.2 million bales of cotton. And as a result, the cotton textile trade deficit has risen substantially for the second consecutive year to a new record of more than 8-million-bale equivalents of raw cotton. In total, U.S. consumers purchased the equivalent of over 19 million bales of cotton in calendar 1998, which indicated a rise of 1.5 pounds in the per capita consumption of cotton to 34 pounds, the highest in 55 years.

#### U.S. Exports, 1998/99

Like mill consumption, U.S. cotton exports have been restrained this season. U.S. exports are projected to fall 44 percent from last season's 7.5 million bales to only 4.2 million, the lowest level since 1985/86. Upland exports are forecast at 3.9 million bales while ELS shipments are expected to reach 300,000 bales in 1998/99. The reduction is attributable to the decline in the U.S. crop, which has left exportable supplies at a minimum, and to very weak worldwide import demand for cotton.

In addition, other major cotton exporters are generating strong competition for limited markets as foreign stocks outside China are projected to increase once again this season. In other words, the stocks of nearly all of the U.S.'s major competitors and most of our customers, are estimated to rise collectively by more than one million bales. And by the end of this season, these stocks are expected to be the highest since 1974/75, no doubt a major reason why demand for U.S. cotton is at a 10-year low.

During the first half of 1998/99, U.S. cotton exports totaled about 2.8 million bales, or a shipment average of 106,000 bales per week. With two-thirds of the forecasted exports already shipped, U.S. exports for the last half of the season need to average only 56,000 bales per week. Meanwhile, commitments (shipments plus outstanding sales) at the halfway point stood at nearly 4 million bales, or 95 percent of the forecast. However, sales beyond the 4.2-million-bale level are needed as some sales are traditionally "rolled over" to the new season. In addition, these remaining export sales will have to be made without the support of the "Step 2" competitiveness program, which expired in mid-December.

#### U.S. Imports and Ending Stocks, 1998/99

With the expiration of "Step 2" and the continued price gap between the U.S. quote and the A-index, the required 10-week count for triggering the "Step 3" import quota is approaching. The first quota is expected to open about March 1 with a quota quantity of approximately 200,000 bales. But despite the possibility of numerous quotas triggering, the likelihood of raw cotton imports of only about 350,000 bales is projected for the 1998/99 season. These raw cotton imports are largely the result of the small U.S. crop which was lacking in certain qualities of cotton needed by U.S. mills.

Despite projections of total demand for U.S. cotton to fall over 22 percent from 1997/98 to 14.6

million bales, demand remains above the reduced crop and stocks are expected to decline from beginning levels. Even including the projected imports, stocks at the end of 1998/99 are forecast to be only 3.4 million bales. Although the actual stock level is below the previous season, the ratio of ending stocks to total use has in fact risen from about 21 percent to over 23 percent this season, and, accordingly, prices to date have fallen.

The combination of the current low prices and low yields will reduce 1998/99 market revenue per acre to its lowest level in over 10 years, but government payments (including contract payments) will provide an average of almost \$120 per planted acre--before crop loss payments are factored in. Government outlays for the cotton program, which tend to rise as prices fall, will exceed \$1.5 billion for the current fiscal year. With the marketing loan differential running at about 10 cents per pound, most of this year's upland cotton production of 13.4 million bales is likely either to enter the loan or receive a loan deficiency payment (LDP). As of early February, nearly 5.0 million bales had entered the loan and nearly 6.0 million bales had earned an LDP.

### **World Cotton Outlook for 1999/2000**

World ending stocks are expected to rise in 1999/2000 as production continues to exceed consumption. The outlook is for larger world production--at 86 to 88 million bales--led by a rebounding U.S. crop, and a similar gain in consumption--to 85 to 87 million bales. At the mid-point of these ranges, world ending stocks--even after excluding China--are expected to climb to their highest share of consumption since the mid-1980's.

### **Foreign Production for 1999/2000**

Foreign cotton production for 1999/2000 is expected to decline by 1 to 2 million bales as smaller crops in China, India, Turkey, Mexico and Australia offset increases in Uzbekistan and the African Franc Zone.

An expected decrease of more than 1 million bales in China's cotton production--to around 18.5 million bales in 1999/2000--accounts for most of the anticipated drop in 1999/2000 foreign production. The Chinese government continues to implement policies designed to lower cotton area and production through reductions in procurement prices. However, many officials are pessimistic about the government's efforts since cotton still remains one of the best cash-earning crops in many parts of China. India's cotton output in 1999/2000 is also expected to be lower based on reduced area as many growers switch to alternative crops due to weakening returns this year as production soars and consumption contracts. Similarly, lower area in Turkey is likely to result from the current depressed conditions in the Turkish textile industry. Cotton area in Mexico is likewise expected to respond to weak demand and competition from competitively priced U.S. cotton. And marginal decreases in Australia's production are projected, as normal rainfall would reduce the potential for dryland cotton.

Two major foreign cotton-producing regions, Central Asia and the African Franc Zone, are likely to increase cotton production next year, despite the current low level of world cotton prices.

With area unchanged based on government-set targets, Uzbekistan's cotton production is expected to rebound from this year's weather-reduced crop. Production in the African Franc Zone, where investment in cotton production will maintain area, is also likely to benefit from a return to normal yields.

#### World Consumption and Trade in 1999/2000

World cotton consumption is forecast to rise 1 to 2 percent from its year earlier level in 1999/2000 as world economic activity improves late in calendar 1999 and during 2000. However, at 85 to 87 million bales, world cotton consumption is still forecast at one of its lowest levels of the decade. Most of the expected continued problems with consumption can be ultimately traced to sluggish economic growth. During the last 25 years, cotton consumption has failed to grow when world GDP growth was below 2.3 percent. (The correlation is clearest when GDP for the calendar year occupying the latter part of the cotton marketing year is used: e.g., GDP in calendar 1998 is relevant to cotton consumption in marketing year 1997/98).

Currently, a modest upturn in economic activity in the year 2000 is foreseen. The U.S.'s phenomenal consumer demand growth is expected to weaken through 1999, picking up only slightly in 2000. Western Europe's consumer demand is expected to be relatively steady through this period. And there is a great deal of uncertainty about the outlook for Japan as it enters the eighth year of its post-"bubble" slowdown. Largely depending on expectations for Japan, various macro-economic forecasters expect either little change or a slight improvement in average economic conditions in developed countries.

For developing countries, the outlook is much better. A more optimistic outlook through 2000 is appropriate given recent events: improving stock markets in developing East and Southeast Asian countries, the return of South Korea's credit rating to investment grade, and the beginning of increased imports across several countries. GDP growth in Asian developing countries is expected to rise substantially in 1999 compared with 1998--albeit GDP growth will simply be less negative in Southeast Asia, but even there a strong upturn is likely in 2000. Little change is expected in China.

Several factors are expected to restrain global consumption growth. One is possible continued inventory adjustments. As a speaker at last year's Outlook Forum noted, changing economic conditions can amplify effects on fiber demand due to changing stockholding through the textile marketing chain. This has probably been a factor in 1998/99's extraordinary consumption decline, and lagged effects could continue in 1999/2000. Another factor is competition from low polyester prices. Price declines for polyester in most Asian markets reported by Cotton Outlook have exceeded the similar year-to-year decline in the A-index, and appear to be reaching new lows. As a result of these offsetting factors, expected world consumption gains in 1999/2000 are forecast at the long-term growth rate of 1 to 2 percent.

Just as 1999/2000 world consumption is not expected to rebound completely from 1998/99's large decline, world trade is not expected to completely recover from this year's losses. The circumstances that led to two of the largest import cuts--China's and Turkey's 1-million-bale

import contractions--are unlikely to reverse, and the decline in Brazil's exchange rate is likely to lead to a still smaller share for imports there. Other importing countries are likely to increase imports slightly, however, and world trade is likely to again equal about 30 percent of world consumption, or about 26 million bales.

## **U.S. Cotton Outlook for 1999/2000**

### **U.S. Area, Yield, and Production**

Preliminary estimates for 1999 U.S. area suggest an increase to about 13.5 to 14 million acres, including about 275,000 acres of ELS cotton. And with average abandonment and normal yields, a U.S. cotton crop of 17 to 18 million bales is indicated, including 550,000 to 600,000 bales of ELS cotton. The mid-point of this range, 17.5 million bales, is more than 3.5 million bales above the 1998/99 weather-plagued crop. However, these estimates are at best an indicator of direction, given the uncertainties surrounding producers' planting intentions and yield variabilities across the Cotton Belt.

U.S. planted acreage is expected to rise marginally in all regions. Cotton area is likely to increase despite the current very low cotton price levels because of depressed prices for alternative crops, concerns about aflatoxin in corn, and the safety net provided by the cotton marketing loan program. December cotton futures fell below 60 cents per pound on February 11, its lowest level since November 1993; however, a comparison of the ratios of cotton prices to corn and soybean prices for the past several years shows that alternative crop prices are also extremely low. The results of a long-term research program by USDA's Economic Research Service on changing producer responses to prices under the 1996 Farm Act indicates that shifts from other commodities to cotton due to relative prices will more than offset the negative effect of current low cotton prices.

Cotton planted acreage in the Southeast and Delta is expected to reverse its recent pattern of decline due to shifts in acreage from other crops, especially corn. Last year's heavy corn price discounts due to aflatoxin infestations in the Delta have generated renewed interest in cotton. In the Southwest, reduced plantings of Pima cotton are likely to be offset by a gain in acres from grain sorghum. And in the far West, upland cotton acreage is likely to about equal last year's weather-reduced level. Some upland cotton acres will shift to Pima cotton in California, due to relatively stable prices and good yields.

### **U.S. Mill Use, 1999/2000**

On the demand side, U.S. GDP is expected to grow more slowly in both 1999 and 2000 than it has in recent years. As a result, slower growth in retail cotton consumption, coupled with increased cotton textile imports, will likely result in mill use exhibiting little change in the upcoming season. U.S. retail cotton consumption could exceed 20-million-bale equivalents in 1999/2000 with only modest growth. However, as in the current season, much of this growth will likely be satisfied with textile imports. An offset to some of the growth in textile imports will be provided by the expected increase in cotton textile exports, largely attributable to NAFTA and

**CBI gains.** Given the effects of ongoing trade liberalization, cotton textile trade will likely continue to expand and play a major role in the quantity of cotton demanded by U.S. mills.

Based on current indications, U.S. cotton mill use in 1999/2000 is likely to range somewhere between 10 and 10.5 million bales, about unchanged from 1998/99. However, the recently released GDP data for 4th quarter 1998 was a pleasant surprise to many, the highest quarterly growth in over 2 years. And if growth continues near this level, retail demand for cotton may rise further, which in turn could push mill use higher than currently projected.

#### U.S. Exports and Ending Stocks, 1999/2000

With higher production, the U.S. is potentially a larger exporter in 1999/2000; but, relatively weak world demand, some export competition from China, and continued large stocks in foreign countries outside China are major factors that will limit U.S. exports from returning to the shipment level of 1997/98. Exports in the range of 5 to 6 million bales are consistent with the world projections outlined here. The mid-point of this range, 5.5 million bales, would be 30 percent above the current season's projection but well below the 5-year average of approximately 7 million bales.

At 5.5 million bales, the U.S. share of world trade would rise above this season's 17.5 percent to about 21.5 percent, but would remain below the 25-percent average of the early 1990's. Under the standard assumption of no policy changes, this analysis assumes no revival of Step 2. The lack of Step 2, the prospect of continued low imports by China, continued exports by China, and rebounding production in Uzbekistan and the Franc Zone together suggest that the U.S. share of world trade should be below its average of the early 1990's.

And despite the projected increase in U.S. exports in 1999/2000, larger production gains are likely to push U.S. stocks higher. Based on these projections of cotton supply and demand, and the likelihood of negligible or no imports during the marketing year, U.S. stocks could rise nearly 2 million bales by the end of 1999/2000. The gain in stocks would imply nearly a one-third ratio of stocks relative to total use, well above this season and the highest in over 10 years.

So you might ask, "What does all this mean for cotton prices or farm income?" As you know, USDA and its employees are prohibited by law from public forecasts of cotton prices, but perhaps just as important as prices are the net income prospects. Based on the scenario presented here, there may be some good news on the horizon. This season, the cotton producer's income from the marketplace was severely reduced by the combination of low prices and low production. Only program payments, in place under the current farm legislation, kept producers' net income per acre above the recent low of the 1995 season. And for next season, current projections for net income for cotton are somewhat positive due to a projected return to normal yields, coupled with the promise of marketing loan benefits if low prices should continue. Although not expected to reach the peaks of recent years, a rebound after two years of decline will be welcomed by all segments of the cotton industry.

# Meeting The Challenges of Producing Cotton in the United States

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A cotton grower suggested to me in 1996 that cotton prices had forever moved to a new plateau. His reasoning was that inflation had driven prices higher and that the typical base range for cotton prices should reasonably be expected to be between 75 and 85 cents per pound. The failure of his analysis was in realizing that cotton is “just another commodity ” and like any other commodity it is subject to wide price swings based on global economic conditions as well as global cotton production trends.

Risk management has become the enlightenment word of the final decade of this millennium. That notwithstanding, a grower’s long-term success in cotton production will be judged by his ability to successfully manage both production and marketing risks. The past generation of cotton growers largely found success via government programs. Success during the early years of my generation was footed in government programs. However, the globalization of world economies, coupled with the movement of United States agricultural policy toward a single world market, has clearly demonstrated that the US cotton grower of the future will obtain an ever and ever insignificant proportion of his revenue from the government.

The challenges of risk management facing today’s cotton grower can be described in terms of: (1) Government Policy, (2) Marketing, (3) Technology, and (4) Weather. These categories are interlocking and highly correlated. The common thread is finance and risk management.

## **Government Policy**

The goals of the 1996 FAIR Act (Federal Agriculture Improvement and Reform Act) were to reduce both the government’s regulatory and financial involvement in agriculture. This legislation was the most dramatic change in farm legislation since the 1930's. The first goal was approached by allowing producers the freedom to produce any crop. The second goal was accomplished by moving from the traditional target price concept in favor of “transition payments” and by a commitment to restructure crop insurance. For the first time since 1933 the producer

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was given total control over his crop mix.. Program payments were decoupled from crop production and a producer's total production was eligible for Commodity Credit Corporation (CCC) loan.

The cautious cotton grower should perceive "transition payments" as the beginning of the end of programs. However, we were able to find 6 billion dollars in emergency funding last year and the 1996 farm legislation was worded so that Congress reverts to permanent legislation in 2002. One must remain skeptical that the era of "no program" is near. Nevertheless, this is very difficult for growers. What is the economic decision criteria a grower should use in the consideration of land and equipment purchases? Thus, we see that major intermediate-and long-run decisions depend on knowing the future direction of government policy. That is, on knowing the unknown, as decisions to purchase land and equipment and at what price depends on the future of government programs.

Thus, from an average payment of 14 cents per pound during the 1985 and 1990 farm bills, the 7 cent average under the 1996 legislation should be viewed a precursor to the elimination of payments in the first decade of the 21<sup>st</sup> century. Additionally, be aware of discussion that payments may be decoupled from land ownership and made only to operators or owner-operators. This necessitates an entirely new structure for landlord-tenant relations.

The FAIR Act removed the safety net of previous farm programs. Since then cotton supplies have been volatile as have prices. However, the essence of the FAIR Act promised growers that the Risk Management Agency (Federal Crop Insurance Corporation) would develop products for cotton. Thus, a major failure of the "intent" of the FAIR Act has been the failure of government to modernize crop insurance with respect to cotton.

Insurance subsidies were raised in 1995 and free catastrophic coverage was instituted. Yet, just like the additional premium subsidy this year, these benefits are of little value to the cotton grower because of the ineffective programs. However, the Risk Management Agency (RMA) has authorized a crop revenue product for the South. Other revenue products are likely to be available in 2000. However, two significant problems exist. First, "good" growers find insurance unaffordable and grossly unfair. This problem will continue until the RMA institutes an effective rate structure. Second, there are not any products that offer a price guarantee above the harvest month futures quote. This implies a very low coverage for a crop year like 1999—the current year. Under the current structure, attempting to insure a price above the market price raises rates dramatically and makes insurability problems worse.

The cotton industry must closely monitor these two problems. There is a major concern that the RMA is looking only at the second problem and not the first. Only when the first problem is solved can crop insurance be viewed as a partner in the cotton grower's risk management strategy. Currently, it is a non-program for most cotton growers. Yet, it cannot be viewed as a substitute for deficiency payments. The following considerations should be debated: raising the subsidy, establish accurate rates, expand revenue products to all cotton regions, devote resources to risk management, and consider risk management saving accounts.

The lack of an effective insurance program, coupled with the burdensome affect on price resulting from an oversupply of foreign produced cotton, frame the current situation and outlook for cotton.

These events have brought focus on cotton imports and the 3-step competitive provision of cotton legislation. In 1996 the Step 3 program allowed an unmanageable amount of import quotas to accumulate. Step-3 import quotas were allowed to build even when US manufacturers were not importing cotton. Then, in 1998 the Step-2 program was allowed to run out of money, thus reducing domestic sales, expanding imports and effectively cutting off export sales. Calendar year 1999 begins with a similar outlook. Both of the provisions need reviewing as the program may increase market volatility.

World trade and the uneven playing field for cotton floats under the umbrella of government policy. With cotton so heavily subsidized in most of the exporting countries, too much cotton moves onto the world market at prices below the true economic cost of production. The result is that global market prices are unnaturally depressed making it difficult for US cotton to compete without a competitiveness program like Step-2. In effect, it brings into question the legislative legitimacy of the FAIR Act for cotton. The next round of WTO trade negotiations must give high priority to this de-facto dumping of cotton in the world market.

The right to delineate production preferences has generated significant structural changes on many farms across the four cotton production regions. For example, between 1995 and 1998 corn acreage increased 74 percent in the Midsouth, 23 percent in the West, 22 percent in the Southeast, and 18 percent in the Southwest (Texas and Oklahoma only). The most dramatic change was in Louisiana where corn acreage increased 213 percent in that same period. Even more dramatic changes have been noted on many individual farms. More than a few Midsouth cotton growers have left cotton altogether in favor of grains. Midsouth and Southeast cotton growers have come to appreciate the agronomic benefits of a cotton-corn rotation. Peanut acreage has expanded on some farms in the Southeast, Midsouth and Southwest. Some cotton growers that did not have peanuts in 1995 now have more land seeded to peanuts than cotton.

These acreage shifts, coupled with the resulting changes in infrastructure shifts necessary to adjust to changing cropping patterns and the decreasing importance of government support, are speeding the transition of farming as a "way of life." Growers slow to recognize this pattern are those that are being moved out of production agriculture. These events are speeding the need for growers to control more and more acreage. Nevertheless, after two successful grain crops, cotton growers have learned that grain profits will not cover a cotton debt. Too, profits from grains have not been sufficient to allow for acreage expansion. The successful grower must expand his operation while controlling his debt-to-equity ratio.

## **Marketing**

Cotton growers are presently held in the vice-tight grip of old crop prices well below the cost of production and facing a planting season that suggests another year of the same. Yet, of the just expired 24-month period that the December 1998 cotton futures contract was traded, January 1997 through December 1998, prices were above the 75 cent level in 15 of those months. Too, on six specific occasions of one week or longer, the December futures contract was above the

76 cent level. Nevertheless, I would guess that over the last six weeks, I have fielded 400-500 questions about “what to do with my old crop.”

Historically, average annual prices received by growers have covered the cost of production in only 8 of every 10 years. Thus, growers have had to extract enough market (and government) income in eight years to cover ten year debts. Recalling that government payments averaged 14 cents per pound under the 1985 and 1990 farm bills suggests that the growers future in cotton production will be determined by his ability to manage price risk. During the days of tight regulatory production control growers became accustomed to using the CCC loan as a primary part of their marketing strategy. They simply entered cotton into the loan program and sold the cotton later in the marketing season when seasonalities suggested higher prices. An outgrowth of this is to make delivery of the physical cotton at harvest, but delay fixing the price until later in the season, using either the December, March, May or July contract. Historically, most growers have rolled the price fixation from contract month to contract month expecting prices to move higher.

This marketing strategy, and its outgrowths, can only be classified as the “hold and hope” strategy. This hold and hope strategy, more often than not, was successful during those times. Yet, the FAIR Act, coupled with the 3-Step competitiveness provision, has redefined the world cotton marketplace. Just as the foreign textile mill has always been a significant market for US cotton, foreign cotton now has an easy path into the US. Too, growers forget that the CCC loan period is now only 9 months, not 18 months. Thus, their decision making horizon has been reduced.

This redefinition of the world marketplace has brought into question another of the time honored traditions of the cotton market...delaying the sale until after harvest. Since 1996 the hold and hope strategy has had dubious results. However, an increasing number of growers indicate both their willingness to use and their actual usage of the cotton options and futures markets. The use of put options for the establishment of a price floor is common with an increasing number of growers. Likewise, the use of a call option that allows for a higher price after the fixation is gaining some understanding. Certainly, the number of growers using option spreads is increasing. This indicates an increasing level of market knowledge.

However, extracting a profit from the market has not historically been the goal of most cotton growers. Rather, they have tended to look for specific prices. The survivors will quickly learn that the market is a tough taskmaster, it gives the test first and the lesson afterward. The marketing lessons will be hard learned, as for nearly three generations the government has been there. There is an overwhelming need for grower marketing plans to become pro-active rather than maintaining traditional reactive strategies.

### **Technology**

The elimination of the boll weevil slowly moves west, but it continues to move. Research and extension lie at the heart of an agricultural community. A high dollar, high risk commodity like cotton demands it. Cotton growers have been masters in accepting and implementing new technology. The worn out adage, you must lower your cost of production will always be true. Innovations in GIS, equipment, precision farming, and biotechnology will flow yearly. The

innovators will succeed, the non-innovators will fall out of cotton. One challenge is for the grower to learn just how costly the extra 10 pounds of yield may be. Growers have been slow to accept this and it is an increasing problem.

### **Weather**

There is nothing unusual about weather disasters. We have good years, bad years, great years and the like. The El Nino and La Nina phenomena have been well documented. These weather cycles, predictable or unpredictable as they are, are at the extremes. Nevertheless, there is a weather disaster somewhere every year. The private market, along with government interaction, has responded with crop insurance programs as discussed earlier. While these programs have been important to some in the cotton industry, the majority of cotton acreage is not covered by insurance. The development of a workable program was “promised” in the debate surrounding the FAIR Act. The absence of such a program leaves the majority of cotton growers without a tool with which to manage weather related production risk.

## THE NEW DIRECTION OF CHINA'S COTTON POLICY

Shi Jian Wei

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All-China Federation of Supply and Marketing Cooperatives

Ladies and Gentlemen, and friends of the cotton industry:

Thank you for your invitation to Mr. Su and me to attend the 1999 USDA Outlook Conference Cotton Session, giving me an opportunity to speak and meet with my new and old friends, exchange information, and discuss issues.

I am going to (1) give a brief explanation of recent changes of China's cotton supply and marketing situation and policy reforms, (2) introduce China's new 1999 cotton policy, and (3) analyze potential policy impacts on production, marketing, and consumption of China's cotton.

### Recent Changes in China's Cotton Supply and Sales

From 1993 to 1995, China's government raised cotton procurement prices significantly to resolve a tight cotton supply. Standard roller gin cotton prices increased from RMB 6,000 per ton (RMB 300 per dan) in 1992 to RMB 6,600 per ton (RMB 330 per dan) in 1993, followed by another increase to RMB 10,880 per ton (RMB 544 per dan) in 1994, and increased again to RMB 14,000 per ton (RMB 700 per dan, Xinjiang RMB 630 per dan) in 1995. Meanwhile, we promoted scientific methods of cotton production that significantly enhanced the farmer's willingness to plant cotton. Therefore, cotton yield and production have increased. In 1997, China's cotton production was 4.6 million tons. This was the third highest production on record, surpassed only by crops in 1984 and 1991. Although severe floods hurt some part of cotton producing provinces of Hubei, Hunan, Jiangxi, Jiangsu, and Anhui in 1998, China's cotton production is expected to be about 4.3 million tons.

While cotton production increased, there were major changes in cotton consumption in China. The market has changed from a shortage to a surplus condition. There are several reasons for this. First, China's raw cotton prices were high. China's domestic cotton procurement price is equivalent to US 76.5 cents per pound. Add in ginning, baling, storage, transportation, interest costs and value added taxes, and China's cotton sale price is about US 96 cents per pound. High prices translated to high costs for domestic mills. Consequently, mills are unwilling to use domestic raw cotton. Second, world cotton prices fell steadily. China's imports of cotton, yarns, and clothes have increased. The sale of domestic raw cotton became difficult. Third, prices of synthetic fibers have decreased, resulting in a gradual decline of cotton use in the mix of textile products. Fourth, since the outbreak of 1997 Asian financial crisis, China's textile exports have decreased greatly. Fifth, China's cotton mills are experiencing structural readjustments and cotton consumption was lowered because of fewer spindles. All above-mentioned factors have created difficulties for sales of China's cotton. Raw cotton inventories are piling up.

## Cotton Policy Changes in China

Cotton has been strictly controlled by China's government for the past several decades. The Government set cotton procurement and sale prices. It authorized the Cotton and Jute Companies (CJCs) to serve as a monopsony to conduct cotton business. No matter how the market supply and demand situation changed, CJCs must buy up the entire cotton production at a preset procurement price. A portion of any unsold cotton could become part of a national security reserve and the remainder kept in CJC for commercial sale in the coming year. As China is moving toward developing a socialist market economy, a centrally planned and managed cotton system is no longer suitable to the new market conditions. In recent years, China's government has implemented a series of policies to help cotton marketing reforms. In 1996, cotton sale prices were allowed to fluctuate plus or minus 4 percent around the standard sale price. Meanwhile, the way of conducting cotton supplies and sales was improved. Buyers and sellers were permitted to conduct business face-to-face through public cotton exchanges and fairs. In 1997, the allowable range of fluctuations of sale prices was enlarged to 6 percent, a rise from 4 percent in 1996. Also, the government decided to convert annual cotton exchange events into a permanent exchange market so that buyers and sellers can trade their cotton all the time. On April 20, 1998, China's government decided to lower the 1998 cotton procurement prices. The price for standard roller gin cotton was decreased from RMB 700 per dan to RMB 650 per dan (Xinjiang RMB 570 per dan) with a 5 percent price fluctuation band. The cotton sale price was also liberalized. In September 1998, government decided to subsidize procured cotton within CJCs. For each ton of procured cotton, government adds a subsidy of RMB 1,140 (RMB 57 per dan), equivalent to US 6.2 cents per pound. The announcement of subsidization policy was caused by the fact that China's cotton procurement price is still higher than the world market price. On the one hand, China's cotton mills cannot afford the high cost, but, on the other hand, China's government does not want to announce a second drop of the cotton procurement price within the same year and risk losing credibility with cotton farmers. Consequently, a financial subsidy targeted to CJC was enacted.

Recently, China has decided to follow a socialist market economy system to implement more cotton marketing reforms in 1999. The goal of these reforms is to gradually establish a new market system for determining the allocation of resources while the government only plays a role of macro-management. The major reform programs are as follows:

First, to establish a new market price formation mechanism under the guidance of government. Beginning September 1, 1999, the beginning of new cotton marketing year, the government will no longer set procurement and sale prices. The Government may intervene in the market by using economic means such as managing CJC's reserves, or through imports and exports to avoid severe fluctuations of cotton prices. Government agencies will announce non-binding guidance procurement price and planting targets based on current market conditions, costs of production, the grain-cotton price ratio, and world market prices. This information will guide cotton production and will balance total supply and demand. State subsidies to the CJCs will be eliminated.

Second, to broaden cotton sales channels. In addition to CJCs, plants for processing fine varieties of cotton under the Ministry of Agriculture, State farms, and certified cotton mills of textile industry can directly buy, process and operate cotton businesses. But individual cotton merchants and uncertified mills are prohibited from buying, processing, and operating cotton businesses.

The certification process will be carried out jointly by Provincial Industry and Commerce Administration and the [local] Bureau of Technical Supervision.

Third, to promote a publicly recognized cotton quality evaluation system. Starting 1999, all commercial cotton sales have to come with a certified cotton quality grade report. Either sellers or buyers can request professional services to evaluate fiber quality. A quality certificate will become the basis for calculating final cotton prices.

Fourth, establish cotton exchange markets to assist cotton orderly sales. China has to establish a cotton trading and exchange network that uses national cotton markets based on major production and consumption areas. The network has to be computerized to track cotton trades. The government will participate in the cotton trading and exchange network activities such as buying or releasing cotton reserves, in order to be able to influence the market supply and demand and prices.

Fifth, continue the government practice of arranging cotton imports and exports through State authorized business entities. The textile industry will be encouraged to use domestic cotton in making products while strictly enforcing processing and trade regulations. Those who smuggle cotton in the name of processing for exports and illegal sales of cotton and yarns from unauthorized merchants will be penalized.

Sixth, promote premium cotton varieties and adjust the regional strategies for planting and production. The policy will be to slow down the fast expansion of Xinjiang's cotton by keeping sown areas for the year 2000 at the current level. Cotton planted areas in Yangtze River and Yellow River will be further reduced. From now on, China's cotton production and farmers' income would mainly come from improved yield and higher quality.

These reforms indicate that China's cotton production, marketing, and consumption will be moving towards a market economy system.

### New Policies and Impacts on Cotton Production, Marketing, and Consumption

It is difficult to predict the potential impacts on cotton production, marketing, and consumption caused by the new cotton policies. There are many factors that influence cotton production and sales including prices, competing crops, the domestic economy, and the world market.

#### Production

The new policy emphasizes that procurement and sale prices will come from the market, not the government, effective September 1, 1999. On January 11, 1999, the government announced that the guiding reference price for cotton procurement in the marketing year beginning in 1999 would be RMB 10,000 per ton (RMB 500 per dan) for standard roller gin cotton. The reference price was lower than 1998 crops by RMB 2,350 per ton (equivalent to US 12.8 cents per pound). This announcement is likely to discourage cotton planting, to reduce cotton production, to lower the costs to the textile industry, and to stimulate cotton consumption.

However, I personally believe that China's cotton area will not decrease significantly. Total planting area may be kept at 4 million hectares (60 million mu). Assuming normal weather, production will be around 3.7 to 4 million tons. One of the reasons for this conclusion is that

grain crops had a bumper year in 1998 and grain prices dropped. Although cotton procurement prices were lowered as well, there are many areas where farmer could get a better return from cotton than grains. In particular, there are more open channels for selling cotton [than grains] in rural areas, therefore, farmers are more willing to plant cotton. Another reason is that cotton farmers have been specialized for generations. It is not easy for them to divert their fields into other crops. Also, most northern cotton and wheat double cropping areas such as Henan, Shandong, Anhui, already have made cropping arrangements for cotton when winter wheat was planted in the Fall of 1998. They can only continue to plant cotton. If cotton producers cannot sell their cotton at a price higher than RMB 10,000 per ton, they would feel the loss of their income. Consequently, planted areas and cotton production will be lowered further in the year 2000. In other words, the new cotton policy's impact on China's cotton production will be more fully realized in the year 2000.

### Consumption

There are two major factors that influence China's cotton consumption. First, there is a relative position of China's domestic price to world cotton market prices. If China's cotton price is higher than the world price, there must be a group of mills that will buy cotton from the world market and thus reduce consumption of Chinese cotton. Second, because of the Asian financial crisis, the outlook for China's exports of textile products is weakening. This also affects domestic mill use. Combining these two factors, plus a consideration that China's economy is facing a structural adjustment, there is unlikely to be a big increase of cotton demand in China. For the next several years, based on my personal view, China's annual domestic cotton consumption will stay around 3.25 million tons. If the world cotton price is lower than US 70 cents per pound, China's domestic sale price of raw cotton to its local mills will be higher than the world market price. We hope for a quick turn-around of the world economy China can sell more textile products. Meanwhile, if the world market price becomes acceptable, we can sell some of our cotton.

Thank you.

(Translated by Hsin-Hui Hsu, USDA/ERS)



## NEW MARKETING DEVELOPMENTS FOR FRUITS & VEGETABLES ADAPTING TO MARKET CHANGES

A.G. Kawamura

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It is exciting to have this opportunity to participate in the 1999 USDA Outlook Conference and to share some thoughts about the very competitive fruit and vegetable business. As a third generation grower and shipper of fresh produce in Orange County, California I feel that our urban experience will offer some interesting contrasts and insights to producers in other parts of the country. I am pleased to appear at this conference as both a farmer and marketer, and I make that distinction because of the significant differences and conflicts between the two occupations.

My brother and I run a medium sized produce operation where we grow @300 acres of celery, 500 acres of green snap beans, 75 acres of strawberries and 200 acres of other vegetables from radicchio to zucchini. We lease all of our farm lands, own our shipping and cooling facility, and also handle and market over 600 acres of produce from other growers. We provide short term financing to most of our growers. Our customer base is local, national and international. We have participated in farmers markets and local roadside stands, and have been sending celery to Hong Kong and strawberries to England for over 30 years. Most of our produce is sold directly to major chain stores and shipped directly from our facility to points throughout North America. We have a very small amount of acreage that is certified organic, but the majority of our acreage would be considered sustainable. In short, we are an urban grower-shipper that has been trying to adapt to the challenges of an increasingly competitive fruit and vegetable economy.

In setting the stage for this discussion it makes sense to take a quick look back some 20 to 30 years at the produce industry. It wasn't too long ago that many of us let our production drive our marketing. We grew it and hoped to sell it. The terminal markets were still the hub of the distribution system, food service was still developing and there were many, many chain stores throughout the country. Over production usually found its way to the consumer in the form of blow out prices, as the demand and supply dynamics seemed to respond predictably. There seemed to be a more efficient safety net out there for over production. You could call a buyer and ask him to go on add this very same week because of unexpected blips in production cycles. You knew that every day you would talk to the same person in terminal markets from Boston, Philly, Detroit, Chicago and that the chain store buyers would be friends for a lifetime. These kinds of relationships defined the produce industry for generations. There was a piece of the proverbial pie for everyone...so what happened? Where are we today?

It would be too simple to say that consolidation in the retail and food service industries, global trade and treaties, higher production costs have driven a competitive stake into the heart of the American producer. There are so many different factors in every region and for every commodity grown. Someone's lemons will always be someone else's lemonade. To depend on another's misfortune for profits is a sad commentary about how this industry operates. You have to wonder

about the sanity of a system that celebrates a freeze in one area or an El Nino in another. Of course, the sanity of our global food supply system is not the discussion for today! What *is* clear today and at least for tomorrow is that we are competing with each others as producers not for the chance to feed each other, but for the chance to earn a living and a profit. The risk that growers and marketers take today is enormous in the way of vulnerability to weather, market supply, the whims of the media and the government. Producers can try to be proactive but invariably must respond and adapt to the changing market place after the fact.

As we head into the new millennium we have so many choices for our production and for our products. So many more than we had 30 years ago. Will it be grown organic, conventional, sustainable, certifiable, local, foreign, hydroponic, hot house, green house, shade house; will it be irradiated, fumigated, processed, packaged, bulk, value added, designer, heirloom; how will it be merchandised, slotted, promoted with MPP funding, found on a website? Can we please re-invent celery the way the cocktail, baby carrot has re-ignited the carrot industry? How do we expand shelf space, increase consumer buyer appreciation? How do we put DOMESTIC FOOD SECURITY at the top of the list of priorities that a hungry nation might want to review? (Of course, that's not the discussion for today!)

Today's discussion was to touch on new marketing developments in the fruit and vegetable economy and how to adapt to those market changes. There is little I can say that hasn't already been described in depth in the myriad of agricultural publications and journals that so adequately cover our industry. Every new edition has interviews and introspections on where the industry is and where it's headed. I think most of us depend on these kinds of communications to keep our fingers on the pulse of the industry. Trade shows and conventions enhance our ability to keep abreast of market trends. Sometimes I feel like a dinosaur as I read article after article describing pioneering businesses flourishing in this competitive environment. Evolution is the process of adaptation and today I feel qualified to speak about the survival of the urban farmer and our experience with urbanization and how it impacts positively and negatively on our ability to compete.

I farm in Orange County, California. It is one of the few counties in the country named after an agricultural commodity. Unfortunately, Orange County can no longer grow oranges competitively. In fact, last year for the first time lemons were a higher value crop than oranges. (This seemed to fit the bankruptcy the county was going through at the time.) As I mentioned before, all of the ground on which we farm is leased. Most of it used to be orange groves. It is ground that is currently worth from \$200,000 to \$1,000,000 per acre. We pay @ \$1000 to \$1500 per acre/year on a lease that is interruptible, that is, the landowner can ask us to vacate the premises at the completion of any crop. Most leases are on a year to year basis as agriculture tends to be an interim use before development. Southern California is mostly dependent on imported water and we pay @ \$400 per acre/foot. The southern part of our county pays up to \$800 per acre/ft. In addition, California has continually exceeded Federal levels for wages, regulations and other business related policies and taxes. I can say without hesitation that we have in Orange County some of the highest combined costs of production in the nation. That is why oranges, sugar beets, iceberg lettuce, asparagus and countless other products aren't commercially grown here anymore, even though we can produce some of the finest quality products anywhere. There are too many other growing regions that compete geographically and

seasonally with these products. The only way to offset these inherently high costs and competitive barriers is to increase yields and improve marketing...or to move.

Many growers have left Orange County over the years and some have quit. but for those of us who are left, we have all modified our crop selection, changed our cultural practices to increase yields and targeted our markets to maximize our real and perceived advantages. Several area growers have reduced their acreage and concentrated on road side stands and stores, and have pursued Certified Farmers Markets as well. They have carefully targeted their production to fit a customer profile in different parts of the county. Specialty crops, ethnic favorites, heirloom varieties, vine ripe advertising has created a steady and faithful clientele. Organic production, where a long term lease or ownership of the land is possible, has given a few growers yet another marketing niche. All of these producers have aided their own destiny by becoming grower-retailers. It has proven to be one of the only ways to pass some of the higher costs on to the consumer.

Our company has chosen to pursue other strategies as well. We have prided ourselves on our ability to make a same day delivery with our produce. We have the ability to load a wide-body LD-3 airfreight container straight from the field in the morning and make it to LAX by the 10am cut-off for a flight to Chicago so the strawberries will be for sale that night on the market or in the chain store. We regularly deliver our green beans the same day to the local chain distribution centers. We have realized that freshness is our best advantage and that same day delivery is worth a lot to a buyer both in terms of shelf life and customer satisfaction. The choice of specific varieties that meet these customer and buyer expectations is critical. We also concentrate our acreage to meet early and late market windows in order to take advantage of our mild coastal climate. The planting and harvest schedules are carefully planned for continuous supply and presence in the market place. Our most recent effort is to create a 'stand in the store' with one of our upscale local chains. We specifically chose to grow an especially delicious strawberry variety and can deliver it by noon directly into the stores and let them merchandise the 'farm fresh' concept to amazed customers. It is no hype to bite into a vine ripe strawberry or tomato, a fresh cut broccoli or sweet white corn. The taste, nutritional value and partnership with the local agricultural community are all positive values that can be promoted. This is a different kind of value added merchandising.

The challenge for urban producers is to create a customer based preference for local grown crops. That preference will positively influence the retailer to pursue and solicit local producers to work in a partnership instead of the 'replaceable supplier' relationship. Agriculture has to be viewed as an asset to the buyer and a resource to a community, not an over priced nuisance that creates dust, tractor noise and mud on roads. Farm tours, pumpkin patches, educational farms, gleaning projects and community gardens are just a few of the interactive ventures that can help build community respect and understanding. The greatest danger to agriculture today comes from a lack of understanding by the public it feeds. In the urban areas of the country the ignorance of city dwellers and policy makers has accelerated the decline of American agriculture. A well meaning urban politician will look at a successful inner city community garden as a replacement for large scale agriculture. This works fine until that garden project gets hailed on, an early frost or someone forget to turn off a hose. Agriculture is too vital to be broken down into preferred aggregates. The act of growing food and fiber is more than just an economic activity. Somehow we must make the connection between diet, nutrition, health and agriculture. Domestic food

security is at the heart of a new strategy for the domestic fruit and vegetable economy. Learning to compete in the 21st century will take a willingness to look for new partnerships and paradigms. This doesn't mean that we don't need imported fruits and vegetables. This does not mean that big agriculture cannot produce side by side with small community producers. The people that would try to divide up agriculture against itself have other agendas driving them. U.S. Agriculture needs to redefine itself before it is defined and confined by non-agriculturists who don't think about how and where their food is produced and expect that their next meal is, and will always be found at the corner grocery store or fast food chain. The complexity of the global food system is really not so hard to understand. The creation of nutritional abundance in this world is the highest, most achievable goal we can work towards. The challenge is for agriculture to create its own destiny at all levels. But that is not the discussion for today...or is it?

## THE OUTLOOK FOR U.S. LIVESTOCK AND POULTRY

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The U.S. livestock sector underwent a difficult year in 1998 as high levels of meat production coupled with a slowdown in export growth resulted in dramatic price declines in the red meat sector. Lower feed prices were insufficient to offset declining prices and the red meat sector is expected to contract in the near term as producers have reduced breeding animals. The poultry sector also faced challenges in 1998; problems with the hatchery supply flock and hot weather slowed the growth of production in the middle part of the year and the economic crisis in Russia resulted in the loss of a major export market. However, strong domestic breast meat prices and low input costs encouraged broiler producers to continue to expand although at a slower rate than in previous years.

In the absence of grain price shocks producers can expect to see moderate production costs over the next 2 years but feed costs are expected to increase through the later part of the next decade. Demand for meats from increasing incomes and growth in export sales through the period will support producer returns stimulating production growth. In the near term, biological lags will determine beef and pork production. Faced with hog prices not seen since the early 1970's producers have reduced their breeding inventories and while pork production in the first half of 1999 is expected to remain above 1998, it will likely fall off sharply in the second half of the year. Beef production is forecast to decline 3 percent this year as producers have placed large numbers of female stock in feedlots and the breeding inventory (beef cows and heifers for replacement) was estimated to be 2 percent lower on January 1, 1999. Broiler production however is expected to increase this year as producers have responded to higher prices and problems in the hatchery supply flock by increasing the number of eggs set.

### **Pork Production to Contract Through 2000, Then Expand**

The current hog cycle traces its roots back to 1994. The liquidation of hogs as a result of low prices in 1994 resulted in a dramatic increase in prices in 1996 and 1997 as newly built large-volume slaughter plants aggressively bid for hogs. Concurrent with high hog prices in those years, grain prices fell from their high levels of 1995/96. Positive returns and optimism for the future expansion of pork exports provided substantial incentive for expansion during 1997 and 1998. The sector itself was also undergoing substantial transformation as a result of the expansion of large coordinated operations located in North Carolina and the western part of the United States. These operations had lower fixed costs per unit, different sources of outside capital and given their size were able to develop contractual marketing arrangements with slaughter plants. Thus, they were more likely to ride out short term declines in prices. Pork

production continued expanding through the fourth quarter of 1998 as constraints in slaughter capacity drove prices to their lowest levels in decades.

Despite low grain prices, the virtual collapse of hog prices in December of 1998 and continued weakness of prices through first half of 1999 will slow and reverse production growth in 1999 and 2000. Beyond 2000, production is expected to expand at about 1-2 percent per year. It is entirely possible that following the shakeout at the end of this hog cycle, the sector may have dampened the hog cycle. Production will increase at considerably lower prices than would have previously been required to trigger a response

Per capita consumption of pork on a retail weight basis is expected to decline slightly from last year's peak of 52.5 pounds per person as production declines through 2000. As production increases through the baseline period, per capita consumption will expand slowly to about 54 pounds by the end of the forecast period. Despite pork's lower cost structure, continued expansion of poultry is expected to provide considerable competition for pork at the retail level.

Pork exports expansion suffered a setback in late 1998 when continued economic weakness in the Pacific Rim was compounded by the collapse of Russia as an export market. Although the donation of pork to Russia in mid-1999 will provide some benefit to the export sector, weakness in the Pacific Rim and Russia will temper export growth through the early part of the next decade. Further competition is expected from the EU which finds itself in an oversupply situation and Canada where pork production is expected to expand. Nonetheless, by the end of the forecast period, U.S. exports are expected to reach about 1.9 billion pounds, 50 percent higher than the 1998 level.

### **Beef Market Share Continues to Slide**

The beef sector continues to adjust to the higher corn and hay prices of 1995/96 which resulted in low feeder cattle prices during late 1995 and 1996. Low returns for cow calf operations caused a reduction in female stock and poor forage in the south kept producers from rebuilding breeding herds in 1998. Despite over 2 percent lower slaughter numbers in 1998, abundant forage in the northern part of the country led to calves remaining on grass longer and boosted slaughter weights and thus beef production. The January 1, 1999 survey of cattle producers indicated that although heifer and cow numbers were lower than 1998, producers were retaining few heifers for replacement. With continued large numbers of cattle placed on feed at the end of 1998, beef production will remain high through early spring before declining 4 to 5 percent in the second half of 1999. Production may fall 3 percent for the year.

Reductions in cattle inventories are expected through 2000. Recovery in cattle inventories is expected to begin in 2001 but the beef sector is likely to come under increasing pressure from expanding pork and poultry production at even lower relative prices. The changing structure of those industries has allowed them to expand production while providing consumers a consistent product at a competitive price. In the beef sector, the highest prices will be received for those animals whose meat is destined for export or domestic hotels and restaurants. As beef is forced to

remain competitive with pork and poultry at the retail level, producer returns will not be sufficient to encourage an expansion to this cattle cycle's 1996 peak. The cattle cycle is forecast to peak in 2003 at 99 million head. After breeding herds are rebuilt in 2000 and 2001, production will increase but is expected to hover at 24.5 million pounds through 2008.

In this cattle cycle, per capita retail weight consumption of beef peaked last year at 68 pounds and is expected to decline gradually to about 58 pounds by 2008. Lower beef production will reduce available supplies in the near term and the expansion of exports later in the forecast period will siphon supplies away from the domestic retail market.

The financial crisis in Asia and tightening supplies of beef in the U.S. during 1999-2001 will limit the expansion of beef exports. Exports in 1999 will be boosted by donations to Russia but steady increases in U.S. prices and continued weakness in the Pacific Rim will temper gains. Mexico is expected to remain a strong market for U.S. beef and as Asian markets recover later in the forecast period, U.S. exports can be expected to grow at about 3 percent per year. Imports will expand over the next several years due to demand for manufacturing beef but after the U.S. cow herd is rebuilt and cow slaughter rises, imports are expected to gradually decline. The U.S. will likely become a net beef exporter in the latter part of the next decade.

### **Broiler Production and Trade Growth Slower through 2008**

The rate of growth in broiler production slowed in 1998 due to high temperatures in the southern portion of the United States and problems in the broiler hatchery supply flock. Strong price pressure might have been felt after the devaluation of the ruble in August virtually halted exports to Russia but high prices for breast meat offset the potential price declines from an oversupply of leg quarters. Thus composite prices remained strong. High bird prices and lower feed prices encouraged producers to expand production. Broiler production in 1999 and 2000 is expected to expand about 5 percent per year.

Growth in broiler production beyond 2000 is forecast to average 3-4 percent through 2008, well below historical rates. Changes in industry structure and technological innovation have allowed the poultry industry to keep production costs from rising as rapidly as in other sectors. However, further technological improvements and vertical integration are forecast to occur more slowly through the baseline period. In addition, increasing market share will become more difficult as total poultry has to compete with increasing quantities of competitively priced pork. Nonetheless, retail broiler consumption is expected to reach 98 pounds per capita by 2008.

In 1998, broiler exports suffered their first decline since 1984. The loss of Russia as an export market in August was too great to be offset by increases in other markets. Exports are expected to decline again in 1999 but gradually increase beginning in 2000. Growth in the future will be tempered by the speed of recovery of Russia and Asia as markets for poultry.

### **Turkeys Under Pressure**

Turkey producers faced 2 years of negative returns which reduced production in 1998 and is expected to limit production in early 1999. Although turkey prices will remain weak relative to

the past several years, declining feed prices will boost producer returns and encourage a moderate expansion through 2002. After that, feed cost increases will outpace increases in turkey prices and production after 2003 will likely increase less than 1 percent per year. Although exports will increase from last year's depressed levels, growth will be slow due to competition from moderately priced pork trimmings. Competition from hams on the domestic market is expected to be strong and in the face of large pork supplies, per capita turkey consumption may decline slightly over time.

### **Eggs Consumption Stable**

Egg production has been fairly profitable and egg production increased almost 3 percent in 1998 and is expected to rise another 2-3 percent in 1999. Per capita egg consumption is forecast to be relatively stable at about 246 eggs. This stability will reflect increases of egg products through consumption of prepared foods. Shell egg consumption is expected to decline slowly through the forecast period.

## THE GLOBALIZATION OF THE U.S. COTTON MARKET

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When I was initially asked to speak on this topic, I was at first overwhelmed and then intimidated by the subject matter. After I caught my breath and gave some thought to the idea, I realized that my views, my approach, and my actions toward the cotton market have been and still are shaped in great part by the recent turbulent and volatile activity in the global economic and financial markets. For instance, there are some days when I wake up and wonder which hat will I be wearing to work based on the business news of that day. Will I wear a currency hat, an Asian stock market hat, a Fed Reserve hat, or hopefully, leave my hedge fund hat at home. It is not just brokers or analysts or business managers who have become attuned to the impact of the world's economic difficulties on cotton demand and therefore prices here and abroad. During the height of the Asian stock market crisis, a customer who is a merchant in the SE, indicated he found himself getting up in the middle of the night to check the Tokyo and Hong Kong stock markets based on their possible effect on cotton futures the following morning. Everyone involved in the US cotton market has become far more aware of a whole host of global factors that are significant in not only our daily dealings but in our projections for US cotton.

The effects of the globalization of the US cotton market have been more obvious this year and last but can be traced back much further. There are two ways in which I will examine the recent globalization of the US cotton market, a timeline perspective and a domino effect. Let us begin by examining the timeline of world events and the direction of cotton prices beginning in the Summer/Fall of 1997. Years of unrestrained growth, questionable lending policies, over-expansion and poor fiscal policies by various countries in the Far East began to take their toll on currency values and stock market prices by August 1997. The crisis appears to have begun in Thailand but quickly spread to Indonesia, Taiwan, Malaysia, South Korea, the Philippines and also encompassed an already weak Japan. Currency values quickly depreciated by at least 10% and in some instances as much as 50% initially. Throughout 1998, continued devaluations became an almost daily event. Many countries were plunged into a serious recession, if not depression, where they have remained with negative GDP growth during 1998 with predictions of the same in 1999 and possibly into 2000. As the purchasing power of these countries dropped, so did their ability to buy US cotton although ultimately as seen this crop year, their ability to export textile products would be greatly improved over time. During 1997/98, the world supply of cotton would grow by almost 3 million bales where as the world demand fell marginally resulting in a jump of world stocks of 3 million bales, 2 million of that housed inside China. From July 1997 to April 1998, the A index fell by more than 17 cents with the US futures falling by an almost identical amount as the market attempted to absorb the higher supply and also stimulate

demand. The last leg of this sell-off in US and World prices would be prompted by a surprisingly high USDA March 31 Planting Intentions for the US followed up shortly by China's entry into the export market with 1 million bales.

By May 1998, a delivery based squeeze struck the July 1998 contract forcing futures to recover all of their loss and ultimately move to new contract highs resulting in a rally of almost 25 cents. Also playing a very prominent role in pushing futures higher was a growing concern for inadequate rainfall adversely affecting acreage in the West Texas region along with low irrigation supplies. Though the crisis in Asia had not eased, our attention was diverted to events at home as each subsequent USDA report reinforced our own ideas of an ever- dwindling US crop. By late June, new crop futures hit a high of 78.00 basis the December 1998 contract and remained in the mid to low 70's range over the next three and a half months as we postulated about just how low US ending stocks might fall. At its lowest level, US stocks were forecast at 2.3 million bales based on a crop of 13.2 million bales, although lower demand held the stocks to usage ratio to a more comfortable 15%. With a crop 30% lower than 1997's and the lowest in a decade, even higher prices, if not now, then later, certainly seemed in the cards. After all, in the summer and fall of 1995, the US cotton futures market rallied from the low 70's to the high 90's in just over 2 months as the crop size was cut by more than 4 million bales to 17.9 million bales. So why not higher prices for the US market in the wake of this year's much smaller crop in the US? During most of July and August of 1998, the A index remained nearly unchanged or only modestly lower. However, by September, the lack of demand and the burgeoning new crop supply began to re-exert itself resulting in renewed downward pressure on the A index and ultimately futures. The lack of demand for cotton and the soon to be followed lower prices proved merely to be symptomatic of the ongoing global economic fears as reflected through the sizeable break in stock market values in the US, Europe and Asia to multi-month lows during September and October, 1998. Part of the financial pressures stemmed from the collapse of Russia's banking system pressuring the ruble to much lower levels which in turn forced Yeltsin's government to default on large foreign loans. Back at home, our interest was deflected to the possible failure of a little known hedge fund, Long Term Capital Management, as its collapse and subsequent losses could have spread to other funds resulting in an ever widening crash here in the US and overseas.

The combined effects of these erratic monetary and currency fluctuations on a global scale reinforced perceptions of just how deep-seated the weaknesses were in many foreign economies. This, coupled with concerns regarding the performance of the US debt markets and the constraints it might put on corporate borrowing, proved significant enough to prompt the Federal Reserve to ease US short term rates on 3 occasions from September to November, 1998.

From September 1998 until January 1999, the A index along with US futures continued their downward movement as buyers remained scarce and supplies hefty. Adding to the US woes was the demise of the Step 2 program as its funding was exhausted leaving US exporters unable to compete for export business and exposing the US to imports sometime late in the winter of 1999. The expiration of Step 2 was not a surprise but did remove the insulation the US enjoyed from poor world fundamentals and therefore low world prices. Adding insult to injury, in mid- January, another shoe fell as Brazil first widened the bans on its currency, the Real, and then allowed the Real to float on the world market. Although concerns about the Brazilian economic fallout were

not as great as the Asian contagion due to its perceived limited exposure, the result was another break to new contract lows by US cotton futures even as the US stock market rebounded from a 2-day sell-off. No sooner had we absorbed the news about Brazil than fears about China following a similar course of devaluation rocked commodity values including cotton, soybeans and grains. Though various high-ranking Chinese officials were quick to deny any plan to devalue the Yuan during 1999, the damage was done as cotton and other commodities dropped once again to new contract lows. This sell-off can best be exemplified through the Commodity Research Bureau Index, a basket of commodity values, which plunged to a 24-year low only last week as crude oil, grains, meats and softs including cotton all experienced a lack of demand and an excess of supplies worldwide.

By mid-February, the USDA confirmed what we had all suspected yet feared in their 1998/99 monthly supply and demand report. World demand was reduced to a 12 year low of 84.6 million bales and despite a world crop that also fell to a 5 year low, ending stocks were projected at 41.6 million, the highest level since the mid 1980's. To put the world usage figure in better perspective, think back to the early 1990's when the Soviet Union broke apart, a political event that qualifies as one the most momentous of this century. The disruption and loss of several million bales of Soviet and Eastern European mill consumption as well as the flooding of several million bales onto the world market required several years to be absorbed by the market place. This huge imbalance kept prices captive and in a trading range of the low 50's to low 60's from 1991 until 1993. The economic damage from the Soviet break-up on commodity prices was significant yet pales in comparison to the current global economic crisis that has encompassed almost every major country and region on this planet.

The effect of this year's poor fundamentals has been to push cotton futures down by more than 25 cents from last summer's highs while depressing the A index about 15 cents since the season began on Aug 1. In addition, this recent sell-off in cotton prices carries futures and the A index down to 6-year lows, last seen in the Fall of 1993.

Now that I have determined the how and the when of world economic events as they shaped US cotton prices, I will demonstrate the effects of worldwide fundamentals on US cotton if viewed as a game of dominos. We know that the initial weakness in overseas currency values in late 1997 substantially increased the cost of buying US raw cotton while the decline in overseas stock market values further reduced foreign buying power. The combined effects lowered cotton imports from the US and other exporting countries, hence leaving a larger 1997/98 crop supply with no home. With the advent of the next crop year, the need for foreign exchange by major exporters such as Uzbekistan started the sell-off in the various growths that make up the A index as sellers increasingly fought for market share. With buyers remaining sparse and an abundance of aggressive sellers, the net effect was a downward spiral of prices that may have only recently gained some stability. This downward spiral of business and of prices is similar to a row of dominos, knock the first one down and they all begin to tumble. It is interesting to note that as futures were breaking into the mid-50's two weeks ago, the A index failed to move much lower from its 55-56 cent level as sellers saw little to be gained by discounting offers while demand remained so weak according to Cotlook's daily commentary.

As the dominos representing the supply side has continued its fall, they have intersected another row of dominos depicting the mill sector that began its drop gradually but has gathered momentum in recent months. In their 1999 Economic Outlook, NCC's Economic Services stated "The demand for textile products is directly related to income. Slowing growth rates across the world's economies spells further difficulties for textile product demand." With foreign consumers economically strapped, foreign mills increasingly were forced to turn to the export market to find a home for their products. Returning to NCC's Outlook, they state "where some foreign textile markets were only 20% export driven, many are now upward of 80%." Although the falling currency values may have first worked against many Southeast Asian countries with their raw cotton purchases, their much weaker currencies have allowed them to sell their textile goods at substantially lower prices to the chagrin of the US manufacturers. Mr. Greenspan's often quoted description of the US as an "oasis of prosperity" explains in large part why the US has been the repository of huge textile imports in the last two years and will continue to be in the near term. By most accounts, US cotton textile imports are up by almost 50% since 1995 and 1996 and according to the Commerce Department, US imports of cotton products through November 1998 increased 18% over the same period last year. Reviewing this same data shows how the fight for textile market share can disrupt traditional sources when previous customary clientele are lost. For instance, Pakistan had been exporting a large portion of its textiles - yarn, fabric and finished goods to Asia but when that market came under pressure from some of the above mentioned problems, Pakistan turned to the US as a home for its products. Per the Commerce Dept, US imports of textiles and apparel from Pakistan grew 37% (by volume) from January to November 1998 compared to the corresponding period in 1997. Pakistan is now considered the second most important source of fabric into the US displacing Mexico and number three in yarn imports just behind Mexico and Canada, the US's NAFTA trading partners. This huge inflow of Pakistani goods has prompted US authorities to take action by meeting with officials from Pakistan two weeks ago here in Washington.

Europe has not been immune to the textile import pressure as they too have been forced to try and compete against a huge inflow of cheaply priced foreign textile products. Per the Feb 5 issue of Cotton Outlook Magazine, "European Union textile interests are keen to discuss with Brussels what steps can be taken to protect their markets from the impact of imports from sources such as Turkey." The fallout for the US and Europe as well as any others in similar straits is a contraction in their own cotton consumption as domestic mills are unable to compete profitably against imports. US cotton consumption is down almost 10% this crop year compared to 1997/98 with little change anticipated in the short term. In the last two months, there have been a series of announced consolidations, closings, and mergers by US textile manufacturers that may involve upwards of 1 million bales of cotton consumption. By some accounts, the majority of this mill usage may be irrevocably lost as manufacturing facilities are moved overseas. Any improvement in US mill usage into the new crop year will be tied to the stabilization of foreign currency rates as it relates to the decrease of textile imports and just as important, the refunding of Step 2.

In each of these steps, we seem to find another reason for the dominos to gather speed as they round the corners in an attempt to complete the tumbling process. We have a major economic crisis in Asia and no sooner does the world begin its recovery but Russia deals us a major blow taking most of the world's stock markets with it. But as we patch this problem and move on, Brazil jumps in our path. We as an industry and as global participants can not but help wonder

who, where and when the next problem will occur. The currency and stock markets appear to have developed a tough skin. Obviously, cotton and other commodities similarly affected have not been so fortunate thus far.

Although this globalization process may appear to have begun less than two years ago, in fact, it has been building for sometime. In the mid-80's a huge shift began in countries such as Pakistan and India to expand their textile manufacturing industry as the foreign exchange earned from exporting finished goods was much greater than that of exporting raw cotton. Countries that made up the former Soviet Union, such as Uzbekistan, have learned this same principle, as attested to by their efforts to build a textile manufacturing industry though it is still in its infant stage. Another country that has greatly expanded its mill capacity in recent years is Turkey. The US has been unique in that it has always enjoyed a large textile manufacturing sector while being a major participant in the exporting of raw cotton, albeit less in some years when we were perceived as only a residual supplier. As George Soros, the great financier said "You have political systems which are national and financial markets which are global." Not only is this true but this principle has been around since before the building of the Great Wall of China. The only difference is that now it does not take as long to move goods or currencies. The high speed at which information is communicated to everyone has exacerbated the ongoing dilemma the US cotton market finds itself in. At the NCC annual meeting held two weeks ago in Memphis, the general view was that every major segment in our industry had been adversely affected by the events of the last two years. From producers and ginner to merchandising and warehousing to manufacturers, everyone has been impacted by the oversupply of and weak demand for raw cotton and textiles not only in the US but abroad as well. Improving the demand at the retail level for textile goods in many Pacific Rim countries would obviously alleviate many of the problems that the US industry is facing as supplies of raw cotton and textile goods would become more manageable. However, that improvement may only come from the stabilization of currency values, rising stock levels, and most important, positive GDP growth.

As we look to the future, there are trends setting the stage for the continued globalization of the US cotton market. We need only check the labels of any newly bought clothing to see this process in action. The fiber content and directions for cleaning are often given in two or more languages. As it relates to manufacturing in the US, a shift in spinning operations from the US to Mexico is underway. Again, per the NCC's Outlook, "this shift may be in response to NAFTA incentives and does involve some joint ventures with US spinners. Though the implications are unclear, this trend may bear on attitudes of various interests in the development of new parity agreements."

In closing, I ask you, are our fortunes tied to those of the Pacific Rim region, South America, Russia and Europe? The answer, in my opinion, is a resounding yes. This year and last, we have been made painfully aware of our connection with the world. As stated earlier, just as we are dependent on them to pull themselves up by their boot straps to help salvage US prices on a long term basis, they look to us as a safe haven for their goods when their own populace can not absorb them. On occasion, we may find our attention focused at home whether the issue is supply or demand-oriented. With Step 2 funding, assuming Congressional approval is granted, we may be partially insulated from the world's fundamentals but not isolated from them. The future of the US cotton market is forever linked with that of the world and all its parts. Thank you for allowing me to speak to you today.

## OUTLOOK FOR DAIRY

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Dairy market conditions in 1999 and 2000 are expected to differ dramatically from the sluggish milk production and record milk prices of 1998. Recent relatively high producer returns are expected to unleash a surge of milk production sufficient to overtake projected milk demand and drop milk prices sharply. However, the timing of these developments is highly uncertain. The full brunt of the production expansion is projected to arrive in 2000, although an earlier appearance is a distinct possibility.

A number of cross-currents affected 1998 milk production. Concentrate feed prices began the year somewhat high but fell considerably as the year progressed. Weather effects were quite adverse in some regions at some times but were quite favorable at other places and times. Supplies of top quality forage stayed tight but supplies of lesser quality alfalfa were large. But, the key feature of last year's milk production was the failure of output, for most of the year, to respond to high prices. Except for weather-related aberrations, milk production was essentially flat from late 1995 until the autumn of 1998.

Milk cow numbers were 1.3 percent below a year earlier in first quarter 1998. The decreases slowly diminished until cow numbers were just 0.7 percent below a year earlier in the last quarter. Moderation in cow number declines was caused by the improved level of 1996-98 returns but probably was less than might have been expected on the basis of past experience.

Milk per cow grew modestly through summer, despite milk-feed price ratios that should have encouraged aggressive concentrate feeding and above-trend increases in milk per cow. Tight supplies of prime hay undoubtedly played a role. Fourth quarter gains were sizable but, like changes in cow numbers, probably not fully consistent with the incentives produced by record milk prices.

Late 1998 production increases likely were the harbinger of things to come throughout 1999 and into 2000. The concentrate ration value is projected to fall 7 to 10 percent, following 1998's 10 percent drop. Returns over concentrate cost will be well below the very high 1998 level but probably will exceed those of any other recent year. The milk-feed price ratio probably will set a record.

Milk cow numbers at the end of 1999 are not expected to be much below current levels. Although the exit of dairy farmers may not change much, the pressure of recent returns should spur expanding producers to pick up the pace. Even without optimal forage conditions, milk per

cow should post a large gain, although it may not fully catch up with trend after the sluggishness of recent years.

Expansion in milk production is projected to accelerate gradually during 1999. Output is expected to rise about 2 percent this year, with gains in milk per cow exceeding 2 percent and easily outweighing the fractional decline in cow numbers. The greatest growth in milk production is not projected to occur until late 1999 or 2000. However, the incentives to expand output have been so large that a surge in production is a possibility at any time.

Brisk economic growth and consumer willingness to spend boosted dairy product demand in 1998. Consumers bought 2 percent more dairy products on a milkfat basis and 1 percent more on a skim solids basis, even though retail dairy prices averaged 4 percent above 1997. Demand for milkfat was particularly strong with sales of butter, cream, cream cheese, and ice cream showing relatively little effect of extremely high prices. Meanwhile, cheese sales rose almost 2 percent, commercial disappearance of nonfat dry milk was about unchanged, and fluid sales slipped fractionally.

Dairy demand is expected to be fairly strong in 1999, but probably will not match that of 1998. Economic growth is projected to be strong, but consumers may not spend with such exuberance. Sales will also be affected by carry-over effects from the high wholesale prices of 1998. Some wholesale buyers probably will make purchasing adjustments based on their experiences of last year--not just current prices. At retail, current year-to-year increases in prices probably are larger than at any time in 1998. The projected increase in 1999 milk production will mean that significantly larger quantities will have to clear commercial markets this year. However, the somewhat softer demand means that they probably will do so only at lower prices.

Commercial dairy stocks at the start of 1999 were fairly moderate. Milkfat stocks were somewhat larger than a year earlier, while skim solids holdings were slightly smaller. Commercial stocks may be a key indicator this year. A quick build-up in stocks might well be an omen of a sustained period of lower prices.

International dairy markets have been mostly adrift. Export supplies have been moderate, in part because of lower output in New Zealand. However, demand softness has kept prices below a year earlier. Russia has purchased some butter but economic problems have greatly limited imports. Similarly, weaker Asian demand has held dry milk prices low. More recent economic problems in Brasil threaten to push some Argentine products elsewhere. Prospects for substantive improvements in 1999 international dairy markets seem dim.

Exports under the Dairy Export Incentive Program (DEIP) will be large in 1999, but there will be a hiatus in new contracts for nonfat dry milk caused by exhausting some key allocations before midyear. In addition, the shrinking amounts allowed under WTO mean that DEIP cannot absorb a large surplus. Sizable purchases of nonfat dry milk are expected to continue in 1999 (the last year of the price support purchase program). Some tightening in markets for separated skim solids may keep purchases somewhat smaller than last year.

Wholesale prices of cheese and butter have been on a rollercoaster ride that may not yet be at an end. Exchange prices of cheese have recovered modestly after January's 65-cent plunge, evidently a correction to an over-reaction and very similar to the earlier pattern of butter prices. Cheese prices may edge somewhat higher before seasonally rising milk production erodes them this spring. Butter prices may stay unsettled. The relative values of milk for cheese and butter-powder may reverse a number of times, and prospects for the seasonally tight second half of the year may be particularly uncertain.

Farm milk prices are expected to regain some stability by late spring-early summer--but at levels much below the second half of 1998 or the start of 1999. The expansion in milk production has begun to overcome dairy demand increases, bringing about a price readjustment. However, the flush season price low is not expected to be extreme. Demand strength is projected to keep spring prices well above 1997 averages. A moderate seasonal increase in milk prices is expected during the second half of the year. For all of 1999, farm milk prices are projected to be about \$14.00 to \$14.75 per cwt, down about \$1 from the 1998 record but still much higher than most of the nineties.

A faster-than-expected expansion in milk output would, of course, reduce 1999 milk prices. However, general strength of early 1999 prices, the recovery of wholesale prices after the initial crashes, the absence of rapid build-ups in commercial stocks, and quite modest price support purchases of powder suggest that substantial market strength persists. Rapid growth in milk output under these conditions probably would have more effect in nullifying second-half seasonal increases than in pushing spring prices to very low levels.

Retail dairy product prices are expected to reach a peak during the first half of 1999 and then decline slightly or hold about steady during the second half. Compared with a year earlier, retail prices probably will be 6 to 7 percent higher during the first half, with the increases diminishing substantially in the second. The farm-retail price spread is expected to grow considerably after the 4-percent decrease in 1998.

The general pattern of a slowly growing dairy industry remains the long-term outlook. Generally favorable milk-feed price ratios will help milk per cow expand about 2 percent per year, with the assistance of genetic and management improvements, structural shifts, and bovine somatotropin. Large numbers of dairy farmers will continue to leave dairying. But, construction of new or dramatically expanded dairy farms is expected to hold declines in milk cow numbers to 1 percent or less in most years.

Demand is expected to trend slowly higher. Gains in cheese sales and in use of dairy products in processed foods are projected to outweigh losses in other dairy sales. The contribution of dairy products to the sensory appeal of many prepared foods lends strength, even though most of the basic dairy products operate in mature markets.

A general tendency for supply to grow slightly faster than demand is expected to result in a slight erosion in real milk prices. However, the relatively equal growth rates and the demise of the price support purchase program imply that year-to-year price changes may vary greatly. Feed conditions, changes in the general economy or international markets, weather, or structural

variability could move prices sharply in either direction.

The experiences of recent years have brought some common presumptions about dairy demand into question. Clearly, last year's butter prices made it very difficult to believe the rumors of the death of milkfat demand. It is true that there has been a very gradual shift of market value from milkfat to skim solids. However, the true trend has always been dwarfed by shorter-run swings in milkfat or skim solids demand. The 1996-98 period, like the mid-eighties, had very strong demand for milkfat while skim solids demand was sluggish, while the intervening years were dramatically different. A sudden cessation in these swings in relative demand seems highly unlikely.

The popular image of dairy product demand is a consumer standing in front of a supermarket dairy case filling a shopping cart. Except for fluid milk, dairy demand is more commonly represented by a wholesale buyer buying ingredients for some type of food preparation, whether in a restaurant, industrial food plant, or even a supermarket itself. Dairy demand has undoubtedly been changed by the growth in the food preparation business--although the direction of some of these changes is quite unclear.

There is some tendency for ingredients in high value-added uses to be less price-responsive at wholesale than the wholesale demand by retailers. However, commercial food preparers have substitution alternatives that are not available to home preparers. Given the uncertainties about even the direction of change, re-estimation of wholesale price responsiveness would seem to be quite important for understanding dairy markets.

Very large individual buyers for commercial food preparation have become common. These buyers typically are not content with generic bulk commodities from the spot markets but insist on special specifications or services. The growing importance of such buyers has had the side effect of diminishing the amount available for trading in the traditional price discovery markets. Some of the recent price volatility may be attributable to the probably irreversible trend toward thin spot markets.

The emergence of a large food preparation industry has lengthened the time between price changes and full response to those changes. Food processors incur substantial cost to reformulate products and change labels. They also tend to be cautious about introducing product changes that may affect flavor or consumer acceptance and to cushion the immediate effect of changes in ingredient costs on prices of their products.

Retail consumers also may be responding more slowly to price changes. For most consumers, purchase of basic foodstuffs now requires an extremely small share of their income. They probably are less aware of price changes and have no compelling reason to alter purchases quickly.

The record wholesale prices of the second half of 1998 did not produce any significant immediate response in product movement. Similarly, the very low butter prices of the early nineties took several years to generate full response, as did the fairly high nonfat dry milk prices of the mid-nineties. Whether or not the ultimate size of the adjustment to prices has changed, the

adjustments definitely seem to develop more slowly, a significant contributor to increased price volatility.

The sluggishness of the production response to the much higher returns of 1996-98 was a bit surprising, particularly to those with memories of the dairy industry of the eighties. Part of the answer probably lies in the greater maturity of the Western dairy industry. The West cannot now easily post the same rapid growth because of the current hindrances of more limited alfalfa supplies, budding environmental problems, and fewer promising areas for new dairy development.

In the rest of the country, dairy farms may be more distinctly separated into two types than has been the case for several decades. Traditionally organized farms have been under long-term income stress and have been exiting at rates reminiscent of the late sixties and early seventies. Most of the partially offsetting herd expansions have come from new “industrial” operations or operators making the leap from traditional farms to such larger operations using highly specialized labor. In contrast, dairy farm growth during the late seventies and eighties tended to be more widespread but in more modest increments and with fewer changes in basic organization.

Development of “new style” Northern dairy farms has not been as rapid as expected. In particular, the relatively high returns of the last few years have yet to accelerate producer expansion plans appreciably. The change from managing cows to managing people is both daunting and highly risky for many dairy farmers. Once plans are carefully thought out and set, they may become very conservative about any alteration.



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